

Interview by Vinson & Elkins  
with Daniel Kelley  
at footnote(s):

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**FINAL**

Date: May 20, 2005

To: Paul S. Maco  
Richard C. Sauer  
William E. Lawler, III

From: Andrea L. Miller

Re: *City of San Diego*; Interview with Dan Kelley

This memorandum summarizes the interview of Dan Kelley. This memorandum does not contain a verbatim or a near-verbatim transcription of this interview, but rather is a general summary of my thoughts and impressions regarding our discussion. It is organized to summarize issues thematically and does not necessarily reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, this memorandum does not attempt to describe every statement or exchange and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case, and does not provide context or explanation of every factual reference. Nor does it address issues of credibility or attempt to reconcile any differences between this interview and the accounts of other individuals.

This memorandum is subject to the attorney client and the attorney work product privileges, as it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC investigation regarding some of the matters discussed in this memorandum.

*General overview of interview.* Rick Sauer and I spoke with Dan Kelley via telephone on April 12, 2005 at 4:00 p.m. Eastern Time for approximately an hour and a half. Dan Kelley's attorney, Patrick Henessey declined to participate in the interview. KPMG was notified by e-mail that the interview would take place but did not respond.

Mr. Sauer began the interview by discussing the role of Vinson & Elkins ("V&E") in the investigation and in its representation of the City (and not the individual City employees) and stated that this memorandum will be provided to the SEC, the U.S. Attorney, and KPMG. Mr. Sauer advised Mr. Kelley that we have his attorney's permission to speak directly with him. Mr. Sauer further explained that we would take notes during the interview

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and that Mr. Kelley would be provided with the opportunity to provide written comments to the memorandum drafted based on those notes (if he so desired), but that V&E preserved final editorial discretion. Mr. Kelley requested that he be given a draft of the summary so that he could provide comments. He asked that we provide the draft interview summary to his attorney. Mr. Kelley confirmed that he was participating in the interview voluntarily.

Mr. Kelley was very forthcoming and cooperative. He advised that he had been questioned by a grand jury, the SEC, and the U.S. Attorney and that he would provide us with as much information as he could in response to our questions.

***Background.*** Mr. Kelley stated that he worked at the County of San Diego ("County") for 22 years before joining the City as Labor Relations Manager in September 1998; he was hired by Bruce Herring. He stated that he encountered a steep learning curve when he began with the City because the departments there were a different culture.

Mr. Kelley worked for the City for approximately four years. He replaced Cathy Lexin as Labor Relations Manager in September 1998 and worked in that capacity until December 30, 2002. Mr. Kelley explained that, when the City Manager reorganized and created Human Resources positions, Mr. Kelley reported to Cathy Lexin (from around December 2002 until he left).

Mr. Kelley stated that the following individuals worked under him: Mike McGhee, Stan Griffith (an Assistant Deputy Director of MWWDD), and Gloria Chavez (a note-taker in personnel), the latter of whom joined the team in Fall 2002.

***Corbett settlement.*** Mr. Sauer asked Mr. Kelley whether he recalled the Corbett litigation. Mr. Kelley stated that he did but could not recall whether he had any role in the way the Corbett settlement was structured. Mr. Sauer asked whether he had any recollection as why the City designated part of the settlement as contingent. Mr. Kelley stated that he recalled the term "contingent", but that it had been a long time ago and he could not recall specifics.

Mr. Kelley noted that he had spoken with many different investigative agencies and that there had not been much focus on Corbett, but if we had questions about Corbett, we should ask Bruce Herring.

***2002 meet and confer.*** Mr. Kelley explained that he was involved in 2002 meet and confer negotiations. Specifically, he was the lead negotiator at the MEA bargaining table and Local 127. Mike McGhee sat with Cathy Lexin at the POA and Local 145 tables. Mr. Kelley stated that there was a "fair amount of coordination" and communication among them

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and that, sometimes they dealt with issues together. Mr. Kelley stated that they generally coordinated on proposals with City-wide impact and what was distributed.

Mr. Sauer asked about the tenor of negotiations and demand level from the unions. Mr. Kelley stated that there is always an expectation from the unions that the City will grant improvements to salary. Mr. Kelley advised that in 2002 there was a strong expectation from the unions for retirement and/or salary enhancements. He explained that, since there were only four unions, each had "ready access to elected officials." By way of example, Mr. Kelley stated that he could be dealing with a grievance issue with a union in the morning and the representative of that same union would be on the doorstep of a council member that afternoon.

Mr. Kelley described why there would be an expectation for an increase in retirement benefit enhancements. He noted that there was a trend statewide for the formula to increase to 3% at 50. Mr. Kelley explained that the trend created a state-wide expectation and that there was a buzz in the labor community to follow the trend for the formula increase. Mr. Kelley advised Mr. Sauer that he could review all entities that had gone to 3% at 50 on the PORAC.org website. Mr. Kelley stated that, notwithstanding the Corbett enhancement, the unions had a further expectation for an increase in benefits.

Mr. Kelley said that it was easy for the City's labor relations representatives to say "no" to the unions but that the ultimate decision was by the Mayor and City Council. His labor relations department laid out options to the City Council and it decided. He noted that there was a "pecking order" as far as the unions were concerned and that the police/fire were first, then general employees, and then the blue collar unit was next such that elected officials responded in that order.

*Comparing the City's retirement system to other retirement systems.* Mr. Sauer referenced the statements in the newspaper describing the City's retirement system as particularly generous and asked Mr. Kelley whether he believed this to be accurate. Mr. Kelley stated that, in some respects he believed it was generous, but in other respects, it was not.

Mr. Kelley compared the City's retirement system to other retirement systems (such as the County's), but stated that the comparison was difficult because, in some respects, they are apples and oranges. Mr. Kelley explained the differences: At the County, the ratio is 2.5% at 55 and is ratcheted up to 3% at 60. At the City, the ratio is 2.5% at 55 and it stays there at 60; it reaches a high of 2.8% at 65. Mr. Kelley added that the City has other programs, such as DROP and allowing employees to take flex benefit contributions and put them into their 401K account if they do not use it (and the County does not have such programs).

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Overall, Mr. Kelley concluded that the City has a generous package for long-term City employees. He stated that the arguments at the bargaining table were typically along the lines of the union suggesting that the City "holds down salaries and, therefore, should reward long-term employees" by creating and continuing such programs.

Mr. Sauer asked Mr. Kelley whether there had been a trade-off between pension benefits and salary increases. Mr. Kelley stated yes, the City "has held down salaries and given retirement benefits instead." Mr. Sauer asked why he believed the City had done this. Mr. Kelley stated that the culture at the City was different and that Jack McGrory had set the tone for employer/employee relations. Mr. Kelley explained that Mr. McGrory had a reputation for being creative in his approach.

Mr. Kelley described political pressures that impacted MP1 and MP2. He noted that the Republican National Convention was coming to San Diego in 1996 and the Super Bowl was coming in 2001/2002 and that there was pressure to make sure that the police were not out on strike during that time (or else that would reflect badly on the City).

**MP2 and the trigger.** Mr. Sauer asked whether Mr. Kelley recalled whether the benefits negotiated during 2002 meet and confer were made contingent on MP2. Mr. Kelley explained that it was not treated as a quid pro quo. He stated that he had read an editorial in the newspaper that referenced him twice because of a letter he had sent to the City Council and Mayor informing them of the general terms and stating something to the effect that "this is contingent on the retirement board acting...." Mr. Kelley explained that it was not contingent in a quid pro quo sense; rather, he had meant that "everything must fall into place if the agreement is to come to fruition." Mr. Kelley emphasized that it was important for labor relations to advise the unions that the offer of certain benefits depended on certain assumptions, including that the agreement be accepted.

Mr. Sauer asked how the link to MP2 arose in the first place. Mr. Kelley stated that "MP2 was developed later on, but the trigger number of 75% was put in our earlier proposals" in or about late April or early March of 2002. Mr. Kelley stated that 75% was the number chosen (in the proposal to reduce the trigger to that number) "at the 11th hour because we needed to put something out there" in an opening negotiation proposal to the unions.

Mr. Sauer asked who came up with the 75% proposed trigger. Mr. Kelley explained that it was discussed at City Council and that he came up with the number for the opening proposals, but that it was an arbitrary number.

Mr. Sauer asked who first advised that the trigger would be an aspect of negotiations. Mr. Kelley stated that he did not recall, but that he recalled that they were putting together a

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proposal and that there were assumptions that needed to be made. He could not recall whether someone had told him to add the number to the proposal.

Mr. Sauer asked whether Mr. Kelley had an understanding early on that SDCERS had to agree. Mr. Kelley stated that "it was not a matter of taking it to SDCERS [but that] labor had to agree." Mr. Kelley stated that the bargaining books for that time period should contain the sequence of proposals and that he left all of his books and disks at the City when he left that show how it all progressed.

Mr. Sauer asked why the concern about hitting the trigger was linked to the new benefit concessions. Mr. Kelley stated that, in his observation, it had more to do with the total concept of being able to pay for the labor package, which included many items, such as the mileage issue (i.e., the cost of operating the car) and salary increases. Mr. Kelley emphasized that the reference to the trigger being hit was raised in the discussions under the City's duty to bargain in good faith – its negotiators knew they could not raise it later in the process unless they had served notice that it would be an element of the package.

Mr. Sauer asked from whom Mr. Kelley received direction from anyone else in the negotiations. He stated that he operated as a team with the City Manager, Bruce Herring, and Cathy Lexin.

Mr. Sauer asked when Mr. Kelley first heard of the concern about the trigger. Mr. Kelley advised that "we did briefings in late November/December 2001 and that there should be documents showing that." Mr. Sauer asked whether Mr. Kelley recalled whether it was late 2001 or early 2002 when the trigger came to fore. Mr. Kelley stated that "it was always a factor in the negotiation process but he could not recall (without reviewing materials) if it was prior to December 2001 or into 2002. Mr. Kelley stated that the specifics of MP2 were developed later on, in or about late April or May 2002.

On the issue of presidential benefits, Mr. Kelley stated that it was an evolving process and that negotiations started in Summer 2001 and he recalled emails regarding presidential benefits as far back as Summer 2001.

Mr. Sauer asked whether Mr. Kelley was aware of the allegation that the benefits were inducements to labor and SDCERS to support MP2. Mr. Kelley stated that, when the negotiations were in progress, "that was not our perspective." Mr. Kelley explained that, during negotiations, he was focused on the issues and getting information back to prepare proposals. He added that he never looked at it as inducing the unions to support MP2 with presidential leave or retirement benefits. Mr. Kelley noted that, at the bargaining table, there could be as many as 40 people.

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Mr. Sauer asked whether the labor side resisted the idea of lowering the trigger. Mr. Kelley stated no, he did not recall resistance.

Mr. Sauer asked whether he had any recollection as to whether retirement benefits were an inducement to labor to agree to MP2. Mr. Kelley stated, "on its face, you probably can't deny it, but we did not rely on it in negotiations." Rather, Mr. Kelley, characterized the negotiations as following a "logical progression." Mr. Kelley emphasized that the understanding of the intended meaning of "contingent" used in this context is important. He explained that the City was bargaining in good faith, but if the modification to the trigger fell through there would be no agreement and no basis for unfair labor practice charges.

Mr. Sauer asked whether the City would have declined to agree to the benefits if there had been no agreement on the trigger. Mr. Kelley replied "I would think so...just as [the unions] would [without the benefit enhancements]." He noted that there is always the possibility that an agreement will not be reached. Mr. Kelley added that agreements are "dicey" and it is generally very tense until the last minute. Mr. Kelley noted that POA did not reach an agreement, but rather there was an impasse because the City was not willing to provide POA with the salary increase it had sought.

Mr. Kelley stated that he believed that it was not so much the union agreeing on the trigger, but more a matter of MP2 and what the City Council was willing to accept. Mr. Kelley noted that Ms. Lexin took the proposal back to City Council several times before it was finalized. Mr. Kelley stated that he did not think that the unions were balking at the trigger.

Mr. Sauer asked Mr. Kelley his thoughts regarding the characterization of the benefit enhancements as an inducement. Mr. Kelley stated that it was not an inducement; rather, it was part of the total package that should not be considered separately.

Mr. Sauer asked how well Mr. Kelley thinks the unions would have done in the bargaining process if the funding level had been high (because the trigger would not have been an issue). He was not sure the result would have been any different. He stated that he believes that the unions already had an expectation for increased benefits.

Mr. Sauer asked whether the unions received a better deal in 2002 because they agreed to (or did not object to) a change in the trigger. Mr. Kelley replied that he did not believe so, adding that he did not recall it being a monumental issue.

Mr. Sauer asked whether the City would have held the line more if relief from the trigger had not been important to the City. Mr. Kelley stated no, explaining that the statewide expectations remained unchanged. Mr. Kelley stated that they would have had a

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creative approach to negotiation and the resulting agreement would have been similar. He believed that "the trigger issue was not driving the final package."

*Union presidential leave benefits.* Mr. Sauer asked whether there was truth to the allegations that the presidential benefits were linked to MP2. Mr. Kelley stated "now, everyone says that," but didn't then. Mr. Kelley provided background on the matter, stating that the problem started with POA because the presidential benefits provided had never been codified and that MEA "got on the bandwagon." Mr. Kelley recalled that there was a folder that had a written agreement between Judy Italiano and Cathy Lexin. Mr. McGhee had tried to locate the POA agreement through POA. Mr. Kelley never actually saw the agreement. Mr. Kelley stated that no formal action had previously been undertaken to approve the agreement that was allegedly memorialized.

Mr. Kelley stated that, in 2001, Ron Saathoff demanded the same benefit that he thought MEA and POA presidents had and Ms. Lexin had advised him that they had not been receiving any such benefit. In September 2001, Mr. Kelley stated that he wrote down Mr. Saathoff's expectation and sent Ms. Lexin an email. Ms. Lexin responded that his expectation was ridiculous. Mr. Kelley stated that Mr. Saathoff's situation was slightly different from that of the union presidents for MEA and POA because he was a full-time City employee, but was receiving union salary, whereas the union presidents for MEA and POA were inactive City employees.

Mr. Kelley stated that, because the agreements with POA or MEA had not been codified, they took the issue to City Council. Mr. Kelley stated that City Council "listened and understood." Mr. Sauer noted that the City Manager initially opposed the proposal, but changed his position. Mr. Sauer asked whether he knew why the City Manager had changed his position. Mr. Kelley stated that he did not recall the turning point; he recalls that the reason was explained to him, but he does not recall what that reason was.

Mr. Sauer asked whether there was any reason to believe that the City Manager changed his position on the issue because there was a deal with Mr. Saathoff and others to support MP2. Mr. Kelley stated that there was no discussion with him about that. Mr. Kelley stated that Mr. Saathoff would not have leveraged his retirement benefit on MP2. Mr. Kelley emphasized that "we operated in good faith at the bargaining table [and they] had Ann Smith, who would have sued us [if we took away the benefits from Judy Italiano]." Mr. Sauer asked whether there was a threat of litigation. Mr. Kelley stated that there was no threat, but an undercurrent of a threat.

Mr. Kelley stated that Mr. Saathoff believed that there was the thread of an agreement, albeit not approved by City Council, which constituted past practice, so Ms. Lexin granted the benefit. Mr. Sauer asked if there was any indication that it was linked to



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Mr. Saathoff's support for MP2. Mr. Kelley knew of none but stated that, on retirement issues, Mr. Saathoff dealt with Cathy Lexin and that he personally had no discussion with Mr. Saathoff about MP2.

Mr. Sauer asked if Mr. Kelley had any reason to believe that it was suggested to Mr. Saathoff that the City would oppose his benefit package if he did not sign onto MP2. Mr. Kelley replied that he did not know one way or another. Mr. Kelley stated that Ms. Lexin had separate communications with Mr. Saathoff. But Mr. Kelley never discussed any such issue with Ms. Lexin.

Mr. Sauer noted that the agreements with the unions recognize that benefit enhancements were contingent on action by the SDCERS Board, but there was no indication in the papers that the union presidents' benefits were similarly contingent. Mr. Kelley stated that he viewed presidential leave as part of the overall total package, which included wages, hours, terms and conditions, etc. Thus, if the union walked away from the other benefits, the union presidents benefits might have gone away too. On the other hand, that might just have resulted in a law suit.

Mr. Sauer asked what if SDCERS refused to accept the total package -- would the City at that point have walked away from all the benefits granted? Mr. Kelley stated that he does not know and that he had told the FBI it would have been a "train wreck" because there would be no resulting agreement. Mr. Kelley stated that the salary ordinance was effective July 1 and that he was not sure what would have happened had MP2 not been agreed to by SDCERS. Mr. Sauer asked whether, if MP2 had not been approved by SDCERS, would particular benefits have been derailed at least temporarily. Mr. Kelley stated that he believed so. He stated that they did not go to City Council until November and, if MP2 had not passed, they might not have gone to City Council at all.

Mr. Sauer asked why the labor union resolution was handled differently from the other benefits as a legislative perspective. Mr. Kelley stated that he did not know why. He explained that he had been asked in the past why do a resolution and not an ordinance. He explained that, at that point, they did not differentiate.

Mr. Sauer asked whether someone in Mr. Saathoff's position (as a member of SDCERS) have the expectation that if MP2 did not pass that he would not receive the benefits. Mr. Kelley stated that he did not know what Mr. Saathoff would think about that; he believed that his expectation was only that they were moving forward.

Mr. Sauer asked whether (as of July 2002) since certain presidential benefits had not been specifically linked to MP2, Mr. Saathoff could have argued that there was no

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connection. Mr. Kelley stated, no, from his (Mr. Kelley's) perspective, it was the total package and presidential leave could not be separated from the rest of the package.

**Grand-parenting.** Mr. Sauer then asked (regarding the grand-parenting aspect) why it was necessary to not impose a 90% cap. Mr. Kelley stated that some people had purchased service credit and the cap diminished the value of the purchased credits. Mr. Kelley stated that Mr. Ryan was "constantly on me" and "pushed the issue incessantly" to ensure that the cap was not imposed. Mr. Ryan was the driving force on that issue. Mr. Kelley added that the unions were not a big push on the grand-parenting issue; even though a number of union employees benefited, it was not the driving force.

Mr. Sauer asked whether Ms. Webster participated in drafting the grand-parenting clause. Mr. Kelley stated no, she kept at arm's length because the grand-parenting provision benefited her and others. Mr. Kelley stated that there was no indication that she was influenced by the fact that she benefited from the provision and that he had higher expectations of her than for her to allow herself to be influenced.

Mr. Sauer asked whether anyone had suggested to him that specific benefits were a factor in the vote on MP2. Mr. Kelley stated that he did not recall. He added that he knew that "they felt pressure just in the course of negotiations, but he did not know that anyone was actually putting any pressure on them" to vote 'yes' on MP2.

Mr. Sauer asked whether, from the interviews that he had with other investigative bodies, there was anything that came out of those interviews that may be relevant to V&E's investigation that we had not already discussed. Mr. Kelley stated that he had advised other investigative bodies that (i) MP1 and MP2 were outgrowths of McGrory and his style (and Bruce Herring, who has noted that "we don't do anything that City Council has not authorized"); (ii) the City departments operate in silos; and (iii) Cathy Lexin's style was such that we observed and inferred that she was not communicating on certain things.

Mr. Sauer asked whether he had any knowledge regarding any alleged improprieties at the City. Mr. Kelley stated that he had read the V&E Report and that his department had nothing to do with the disclosure end. He added that labor negotiations are very removed from that. Mr. Sauer asked whether he had heard anything to suggest that there were improper incentives to SDCERS to support MP2. Mr. Kelley stated that he had heard that recently from news reports, but not at the time.

Mr. Kelley emphasized that he would like for us to understand that the meaning of "contingent" is not how it is portrayed in the newspaper; rather, it was simply used to convey that there were steps that must be taken before an agreement is reached (and assumptions underlying the agreement).

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Mr. Sauer thanked Mr. Kelley for his time. Mr. Kelley advised that he would like to review the notes from the interview. Mr. Kelley asked that we feel free to call him should we develop additional questions.

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